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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

ANCHOR COUPLING COMPANY, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The petitioner, Anchor Coupling Company, Inc., respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit entered in this proceeding on May 28, 1970.

OPINION BELOW

The opinion of the Court of Appeals, reported at 427 F.2d 429, appears in the Appendix hereto. The findings of fact and conclusions of law of the District Court for the Northern District of Illinois, Eastern Division, also appear in the Appendix.

JURISDICTION

The judgment of the Court of Appeals for the Seventh Circuit was entered on May 28, 1970. A timely petition for rehearing en banc* was denied on July 31, 1970 and this petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Whether, after five years of litigation the pendency of which materially interfered with taxpayer's business, a $600,000 settlement payment was deductible as an ordinary and necessary business expense under § 162(a) of the Internal Revenue Code of 1954 or was a non-deductible capital expenditure under § 263 of the Code.

2. Whether the Seventh Circuit was correct in abolishing the "primary purpose" test even though this Court recently ruled that the "primary purpose" test was applicable in appropriate circumstances "to determine the tax treatment of costs incurred in litigation affecting a taxpayer's title more or less indirectly".

STATUTORY PROVISIONS INVOLVED

United States Code, Title 26:

§ 162(a) In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

§ 263(a) General rule.—No deduction shall be allowed for

(1) Any amount paid out for new buildings or

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* Set forth in the Appendix

for permanent improvements or betterments made to increase the value of any property or estate.

STATEMENT OF THE CASE

For several years prior to 1956 the founders and principal officers and shareholders of Anchor Coupling Company, Inc., Walter Fritsch and Charles Conroy, had been actively considering various proposals pursuant to which Anchor would affiliate with a larger company either by merger or by a sale of its assets. In the winter of 1956 they began negotiations with Borg-Warner Corporation with a view to the purchase of Anchor's assets by Borg-Warner. The correspondence between Anchor and Borg-Warner left open certain questions among which was the need for suitable assurances for the retention by Borg-Warner of Anchor's executives. Subsequent meetings between Borg-Warner representatives and about ten executives of Anchor working immediately subordinate to Conroy and Fritsch were not fruitful, and by the fall of 1956 Conroy, Anchor's President, terminated further discussions with Borg-Warner. Fritsch, however, continued to believe that Anchor's assets should be sold to Borg-Warner.

In October of 1956 Borg-Warner filed an action in the state court against Anchor, Conroy and Fritsch seeking specific performance of what Borg-Warner alleged to be an agreement to sell Anchor's assets to it for $4,025,000. Fritsch answered the complaint saying he believed there was a fair contract with Borg-Warner. Anchor and Conroy filed motions to dismiss which were granted by the trial court. An amended complaint was filed; again Conroy and Anchor filed motions to dismiss which again were granted by the trial court. On Borg-Warner's appeal to the Su-

preme Court of Illinois, it was held that the amended complaint stated a cause of action and that the issue of whether the parties had entered into a binding contract involved questions of fact to be resolved at trial. See *Borg-Warner Corporation* v. *Anchor Coupling Company, Inc.*, 16 Ill. 2d 234, 156 N.E. 2d 513 (1958). On remand Anchor and Conroy answered the amended complaint and denied its substantive allegations.

Almost five years after the filing of the first complaint, the trial of Borg-Warner's action commenced in May of 1961. After two days of testimony, it was recessed for the summer, there being no jury. During the summer recess, settlement discussions took place which led to a November, 1961, settlement agreement and dismissal of Borg-Warner's action. Anchor contributed $600,000 to the $1,000,000 paid to Borg-Warner pursuant to the settlement agreement.

On its income tax return for its fiscal year ending June 30, 1962, Anchor deducted, as an ordinary and necessary business expense, its $600,000 share of the settlement payment to Borg-Warner. This deduction was first disallowed because the Internal Revenue Service was then of the opinion that "the liability [in Borg-Warner v. Anchor Coupling] was not that of the corporation but of the officer-stockholders". The Service did not disallow the deduction as an ordinary expense by Anchor of the approximately $148,000 of legal fees paid by it to defend the Borg-Warner litigation.

The additional tax due because of the disallowance—$382,353.12—was paid in September, 1966, and the instant action for a refund commenced in September, 1967. At the trial and before the Court of Appeals, the Government contended that the payment was not deductible because made "in defense of title".

After trial the District Court, among other things, found the facts to be that:

"4. The pendency of [the Borg-Warner] litigation in the five years between October, 1956 and November, 1961 had an adverse effect upon plaintiff's day-to-day operations. On advice of counsel, and as the result of the litigation, Anchor curtailed necessary expenditures despite rapidly increasing demand. As a result of the pendency of the Borg-Warner litigation, plaintiff's sales and its income remained stagnant. As a further result of the pendency of the Borg-Warner litigation, plaintiff's competitive position within its industry deteriorated.

"5. In September and October, 1961 there were settlement discussions with a representative of Borg-Warner, as a result of which agreement was reached whereby the litigation would be settled and dismissed by payment of $1,000,000 to Borg-Warner, and of this sum plaintiff would contribute $600,000. This proposed settlement was submitted for approval to plaintiff's shareholders on October 26, 1961 with the recommendation of plaintiff's counsel, Mr. Robert Burdett, that the settlement be approved. Mr. Burdett stated his belief that the litigation would terminate favorably to plaintiff if carried to conclusion, but that an additional three to four years of litigation would be required and that the adverse effect of the litigation upon plaintiff's operations would continue" . . . .

"6. Plaintiff's $600,000 payment to Borg-Warner was made in good faith and was reasonable in amount. The payment was made with a present business purpose to free plaintiff from the constraints imposed upon its business operations by the pendency of the litigation. The $600,000 payment in question bore a direct and proximate relationship to plaintiff's operations and to the production of income from such operations and was made to conserve and protect property held by plaintiff for the production and generation of income." (App. pp. 1-2).

The Court reached the following conclusions of law:

> "3. Plaintiff has established by a preponderance of the evidence that its payment to Borg-Warner of the sum of $600,000 on November 14, 1961 was an ordinary and necessary business expense within the meaning of Section 162(a) of the Internal Revenue Code, 1954. Kornhauser v. U.S. 276 U.S. 145 (1928); Comm'r v. Heininger, 320 U.S. 467 (1943); Comm'r v. Tellier, 383 U.S. 687. Plaintiff has established by a preponderance of the evidence that the $600,000 payment was not made in defense of title within the meaning of Section 1.263(a)-2(c) of the Regulations to the Internal Revenue Code, 1954. L.B. Reakirt, 29 B.T.A. 1296 (1934), aff'd 84 F.2d 996 (6th Cir. 1936); Ruoff v. Comm'r, 277 F.2d 222 (3rd Cir. 1960); Allied Chemical Corp., v. U.S. 305 F.2d 433 (Ct. Cl. 1962); Alleghany Corp., 28 T.C. 298 (1957), acquiescence 1957- 2 Cum. Bul. 3; Rassenfoss v. Comm'r, 158 F.2d 764 (7th Cir. 1946).
>
> "4. Deduction as an ordinary and necessary business expense on plaintiff's U.S. Income Tax Return for the fiscal year ending June 30, 1962 of plaintiff's $600,000 payment to Borg-Warner on November 14, 1961 was erroneously disallowed by defendant, and plaintiff, accordingly, is entitled to judgment in the sum of $382,353.12 with interest thereon as provided by law from September 15, 1966." (App. pp. 3-4).

The judgment of the District Court was reversed by the Court of Appeals, which said it agreed with the Government* that the "primary purpose" test of its earlier *Rassenfoss* decision, relied on by the District Court, was no longer appropriate "in light of the Supreme Court's decisions in *United States* v. *Gilmore*, 372 U.S. 39 (1963); *Woodward* v. *Commissioner*, [397 U.S. 572] (1970); and

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* Actually, the government never took such a position either in this case or in the *Woodward* and *Hilton* cases. All it did in this case was invite the Seventh Circuit's attention to the *Woodward* and *Hilton* opinions which were handed down after oral argument in this case (app. p. 15).

United States v. *Hilton Hotels Corp.*, [397 U.S. 580] (1970)." (App. p. 8). The Court of Appeals held that "the district court erred in considering the possible consequences of the failure to settle on Anchor's current operations and the taxpayer's motives in entering into the settlement", found that "Anchor [had] protected ownership to its assets by removing Borg-Warner's claim through the settlement payment of $600,000", and hence the Commissioner was correct in denying the deduction claimed by Anchor because "payments made in settlement of actions for specific performance should be treated as capital transactions". (App. pp. 8-13). Referring specifically to its own previous *Rassenfoss* opinion and the four other opinions from the Court of Claims, Third Circuit, Tax Court and Board of Tax Appeals specifically relied upon by the District Court, the Court of Appeals said:

> "We decline to follow those cases to the extent that they are inconsistent with the result reached in this case". (App. p. 14).

REASONS FOR GRANTING THE WRIT

1. The Decision Below Is In Conflict With Many Decisions Of This Court.

(a) *The decision below conflicts with the very recent Woodward and Hilton Hotels decisions.* On April 20, 1970, this Court decided companion cases, *Woodward* v. *Commissioner*, 397 U.S. 572 (1970) and *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580 (1970), which dealt with the tax treatment of appraisal litigation expenses. In *Woodward*, this Court said:

> "More difficult questions arise with respect to another class of capital expenditures, those incurred in 'defending or perfecting title to property'. Treas. Reg. on Income Tax § 1.263(a)-2(c). In one sense, any lawsuit brought against a taxpayer may affect his title to property—money, or other assets subject to lien. The

> courts, not believing that Congress meant all litigation expenses to be capitalized, have created the rule that such expenses are capital in nature only where the taxpayer's 'primary purpose' in incurring them is to defend or perfect title. See, e.g., *Rassenfoss* v. *Commissioner*, 158 F.2d 764 (C.A. 7th Cir. 1946); *Industrial Aggregate Co.* v. *United States*, 284 F.2d 639, 645 (C.A. 8th Cir. 1960). This test hardly draws a bright line, and has produced a melange of decisions, which, as the Tax Court has noted, 'it would be idle to suggest . . . can be reconciled.' *Ruoff* v. *Commissioner*, 30 T.C. 204, 208 (1958)." (397 U.S. at 576).

This Court held that the "primary purpose test", although "uncertain and difficult" of application, "may be the best that can be devised to determine the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property more or less indirectly, and that thus calls for a judgment whether the taxpayer can fairly be said to be 'defending or perfecting title'." (397 U.S. at 577). However, this Court went on to hold that the "primary purpose" doctrine had no application to cases where the litigation giving rise to the expense had its origin in the process of *acquisition* or *disposition* of property.*

Thus, on April 20, 1970, this Court recognized both the need for the court-created "primary purpose" rule and the fact of its widespread acceptance. The opinions of the Seventh Circuit in *Rassenfoss* v. *Commissioner*, 158 F.2d 764 (7th Cir. 1946) and that of then Circuit Judge Blackmun for the Eighth Circuit in *Industrial Aggregate Co.* v. *United States*, 284 F.2d 639, 645 (8th Cir. 1960) were set forth as examples of the application of that rule.

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* The Seventh Circuit in *Hilton Hotels* had deemed the "primary purpose doctrine" as both applicable and controlling. *Hilton Hotels Corp.* v. *United States*, 410 F.2d 194 (7th Cir. 1969), *rev'd* 397 U.S. 580 (1970).

But the Seventh Circuit in its May 28, 1970, opinion in this case rejected its own "primary purpose" doctrine as no longer appropriate. Relying on its mistaken belief that this Court in reversing its *Hilton Hotels* opinion and affirming *Woodward* had rejected the "primary purpose" rule, the Seventh Circuit specifically disavowed its *Rassenfoss* opinion. (App. pp. 8, 13-14).

Petitioner finds nothing in the *Woodward* or *Hilton Hotels* opinions suggesting that the primary purpose rule has been rejected in whole or in part by this Court, as now ruled by the Seventh Circuit. On the contrary, where, as here, the taxpayer was not involved either in the acquisition or disposition of property, this Court plainly held that the primary purpose rule may be the best test that can be devised to determine the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property more or less indirectly.

The opinion of the Seventh Circuit in this case thus clearly conflicts with the opinions of this Court in the *Woodward* and *Hilton Hotels* cases.

(b) ***The decision below also conflicts with a long line of decisions of the Supreme Court allowing the deduction of expenditures arising from business litigation.*** For many years this Court has consistently held that expenses incurred in resisting litigation threatening the destruction of a business "are ordinary and necessary expenses", even though such litigation might occur only once in the lifetime of that business. *Comm'r* v. *Tellier*, 383 U.S. 687, 690 (1966); *Comm'r* v. *Heininger*, 320 U.S. 467 (1943); *Welch* v. *Helvering*, 290 U.S. 111, 114 (1933); *Kornhauser* v. *U.S.*, 276 U.S. 145 (1928).

The test for deductibility for litigation or other expense

as an ordinary and necessary business expense is not whether the expense frequently occurs in the day-to-day operations of the business; rather, the test is whether the expense is "directly connected with, or *** proximately resulted from ", the taxpayer's business. *Kornhauser* v. *U.S.*, 276 U.S. 145, 153 (1928). See also *Trust of Bingham* v. *Comm'r*, 325 U.S. 365, 376 (1945). Clearly, therefore, under the tests set forth in *Tellier*, *Heininger*, *Welch*, *Kornhauser* and *Bingham*, the $600,000 payment of Anchor to free itself from the "constraints imposed upon its business" was an ordinary and necessary expense. It was more than directly connected with Anchor's business: it was mandatory if Anchor was to resume normal operations. It not only "proximately" resulted from Anchor's business, it was the direct result of a lawsuit which had its origin in business negotiations which, as the District Court found as a fact, "were normal occurrences in the operations of business concerns situated similarly to plaintiff". (App. p. 1).

Mr. Justice Cardozo, in *Welch* v. *Helvering*, 290 U.S. 111 (1933) said that for an expense to be classified as "ordinary" it need only be shown that it is a "common and accepted means" of accomplishing the desired result. (290 U.S. at page 114). The most common and accepted means of eliminating the adverse business effects of a pending lawsuit is surely a cash settlement which ends it.

The decision below considered the case before it as one requiring the application of the rule pertaining to the acquisition or disposition of property. In this it erred. The expenditure of Anchor involved neither the acquisition nor disposition of property. All that was involved was expense arising from business litigation which, even if a "once in a lifetime" matter, has long been held by this Court to be deductible under § 162.

2. The Decision Below Conflicts With Decisions Of Other Circuits.

(a) ***By repudiating the "primary purpose" rule, the decision below conflicts with those circuits which adhere to that rule.*** **In its opinion in *Woodward*, this Court said that because the courts did not believe that Congress meant all litigation expenses to be capitalized they "created the rule that such expenses are capital in nature only where the taxpayer's 'primary purpose' in incurring them is to defend or perfect title." (397 U.S. at 576) The two cases referred to by this Court as examples were, as set out above, the Seventh Circuit's *Rassenfoss* decision and the Eighth Circuit's decision in *Industrial Aggregate Co.* v. *United States*, 284 F.2d 639, 645 (8th Cir. 1960). Since the Seventh Circuit in its opinion in this case has rejected its earlier *Rassenfoss* opinion, there now exists a conflict between the Seventh Circuit on the one hand, and, on the other hand, the Eighth Circuit and all the other Circuits which apply the primary purpose rule in those situations affecting a taxpayer's title to property more or less indirectly.**

(b) ***In disallowing the deduction of the sum paid by Anchor to settle the Borg-Warner case, the decision below conflicts with decisions of the Second Circuit and Tax Court.*** **The opinion of the Seventh Circuit in this case also conflicts with decisions by the Court of Appeals for the Second Circuit and the Tax Court of the United States, establishing the rule that sums paid in the good faith settlement of litigation arising from taxpayer's business are deductible under § 162. This rule and its basis was set forth by Judge Friendly in *Ditmars* v. *Commissioner*, 302 F.2d 481, 485 (2 Cir. 1962) as follows:**

> **". . . Generally, the expense of resisting a claim arising from a taxpayer's trade or business is 'ordinary**

and necessary' and therefore deductible under § 162. *Kornhauser* v. *United States*, 276 U.S. 145, 48 S.Ct. 219, 72 L.Ed. 505 (1928); *C.I.R.* v. *Heininger*, 320 U.S. 467, 64 S.Ct. 249, 88 L. Ed. 171 (1943); *Helvering* v. *Hampton*, 79 F.2d 358 (9 Cir. 1935). Deductibility is not limited to instances where the defense was successful: the highest authority has sanctioned the deduction of legal 'expenses resulting from the defense of a damage suit based on malpractice, or fraud, or breach of fiduciary duty *** without regard to the success of the defense', *C.I.R.* v. *Heininger*, 320 U.S. at 472, 64 S.Ct. at 253, 88 L.Ed. 171. Amounts paid in satisfaction of a judgment on such a claim are likewise deductible, *Helvering* v. *Hampton*, supra; *hence amounts paid in settlement, in the exercise of a good faith business judgment, must likewise be, Levitt & Sons* v. *Nunan*, 142 F.2d 795 (2 Cir. 1944); *Jerry Rossman Corp.* v. *C.I.R.*, 175 F.2d 711 (2 Cir. 1949); *C. Ludwig Baumann & Co.* v. *Marcelle*, 203 F.2d 459 (2 Cir. 1953); *C.I.R.* v. *Macy*, 215 F.2d 875 (2 Cir. 1954)."

"* * * the conduct of almost any trade or business will give rise to claims, many invalid but some valid; resisting such claims, paying judgments rendered on some, and *settling others, is thus an 'ordinary and necessary' expense of 'carrying on any trade or business'* within § 162." (Emphasis added).

See also, *Wm. L. Butler*, 17 T.C. 675, 679 (1951); *Great Island Holding Corp.*, 5 T.C. 150, 163-64 (1945).

There can be no question but that the conduct of Anchor's business gave rise to Borg-Warner's claim and that the amount paid in settlement of it by Anchor constituted the exercise of a good faith business judgment. The fact findings of the district court covered these matters in detail. In disallowing the settlement payment as a deduction under § 162, the Seventh Circuit is, therefore, in direct conflict with the Second Circuit and the Tax Court.

(c) ***The decision below also conflicts with decisions of the Court of Claims, Tax Court and rulings of the Internal Revenue Service in that it has rejected the well recognized differences in income tax treatment between (1) expenses arising out of the disposition of capital assets as opposed to expenses arising out of abandoned negotiations concerning a possible disposition of assets, and (2) expenses paid in the acquisition or disposition of property as opposed to expenses paid in protection of an existing property right or business.***

(1) What this Court had before it in *Woodward* and *Hilton* were cases involving the question whether the expenditures in issue should be capitalized as are "legal, brokerage, accounting and similar costs" incurred in the acquisition or disposition of capital assets. Application of the "origin" test of *Gilmore* led to a determination in each case that the origin of the litigation expense was in the "process of acquisition itself". Subsequent cases in other circuits have followed Woodward where litigation expense was incurred in connection with the sale of capital assets. *Helgerson et al.* v. *U.S.*, 426 F.2d 1293 (8th Cir. 1970); *Third National Bank in Nashville et al.* v. *U.S.* 427 F.2d 343 (6th Cir. 1970).

But what the Seventh Circuit has done in the decision below is confuse the process of acquisition or disposition of capital assets with the process of *discussing* the *possibility* of the acquisition or disposition of capital assets. In so doing it has put itself in conflict with the Court of Claims, Tax Court and the Internal Revenue Service, which all adhere to the rule that when a merger, sale of assets, or other similar transaction, is abandoned, the related expenditures are presently deductible as ordinary and necessary business expenses and are not required to be capital-

ized. *Picker* v. *U.S.*, 371 F.2d 486, 498-99 (Ct. Cl. 1967); *Doernbecher Mfg. Co.*, 30 B.T.A. 973, 986 (1934), acquiescence XIII-2 C.B. 6; *Sibley, Lindsay & Curr Co.*, 15 T.C. 106, 110 (1950), acquiescence 1951-1 C.B. 3. In Revenue Ruling 67-125, 1967-1 C.B. 31, 32 it is stated as the position of the Service:

> "The split of the stock of the surviving corporation and the proposed redemption of a portion of its stock operate to change the capital structure of the corporation for a period of indefinite duration. Thus, the legal fees incurred for tax advice on these transactions represent expenditures incident to the change of the capital structure of the surviving corporation. However, if the taxpayer can subsequently establish that it has made a final decision not to carry out the redemption, the costs attributable to the proposed redemption may be deducted in the taxable year in which such a decision was made. See *Doernbecher Manufacturing Co.* v. *Commissioner*, 30 B.T.A. 973 (1934), acquiescence, C.B. XIII-2, 6 (1934), appealed on other grounds."

This is precisely what happened in the present case. The $600,000 payment represented the final act in the abandonment of the proposed sale of Anchor's assets considered by Borg-Warner, Charles Conroy and Walter Fritsch in February, 1956.

(2) The Court of Claims, in *Brown-Forman Distillers Corp.* v. *U.S.*, 132 F.Supp. 711 (Ct. Cl. 1955), held that sums paid in settlement to avert litigation covering ownership of real property upon the closing of a city street were presently deductible, the Court of Claims stating (132 F.Supp. at p. 717) the test to be "[I]f it was paid in the acquisition of property it should be capitalized, but if paid in the protection of an existing property right it should be deducted as an expense." And the Tax Court, in *Cubbedge Snow*, 31 T.C. 585, 591 (1958), acquiescence, 1959-1 C.B. 5, said it is

"well established" that "expenditures made to protect or promote a taxpayer's business, and which do not result in the acquisition of a capital asset, are deductible" as ordinary and necessary business expenses. On these tests Anchor's right to deduct the $600,000 is clear: the expenditure was *not* made "in the acquisition of property"; the $600,000 clearly *was* paid "in the protection of an existing property right", to protect and promote Anchor's business. See also Revenue Ruling 56-359, 1956-2 C.B. 115.

But the Seventh Circuit has ruled in this case that the expenditure of Anchor which that Court says "protected ownership" should not be deducted as an expense. Since Anchor acquired no property by this expenditure, the Seventh Circuit decision is at odds with the previous law on the subject.

One source of the Seventh Circuit's error is its inability to discern the distinction in tax treatment between expenditures to *protect* property and expenditures to *defend or perfect title* to property. The former are deductible as business expenses; the latter are not. Treas. Reg. on Income Tax § 1.263(a)-2(c). Thus the two cases which the Seventh Circuit states (App. p. 13) supports its analysis, *United States* v. *Wheeler*, 311 F.2d 60 (5th Cir., 1962), cert. denied, 375 U.S. 818 (1963) and *Wise* v. *Commissioner*, 311 F.2d 743 (2d Cir., 1963), both involved expenditures to erase clouds on the taxpayer's title. In one, *Wise*, the cloud was an admitted option to purchase real estate; in the other, *Wheeler*, the cloud was an "admitted written contract signed by the tax payer". In each case the expenditure *perfected* title and was held to be capital in nature. So also, in a very recent Tax Court case, *Stass Reed*, 55 T.C.—, No. 6, where a taxpayer's expenditures grew out of the fact that her "ownership of the property was less than complete" and hence her

expenditures to remedy the situation were deemed capital in nature. Neither the facts nor the principles of those cases apply here. Anchor's payment ended business litigation involving no dispute as to its title to anything—it was made, as the District Court found, to *protect* its property by relieving Anchor "from the constraints imposed upon its business operations by the pendency of the litigation" (App. p. 2).

3. The Decision Below Raises Important Issues In the Tax Treatment Of Litigation Expenditures Concerning Or Related To Capital Assets.

We have shown above the various ways in which the decision below conflicts with decisions of this Court and other federal courts. That decision also casts doubt on the tax treatment of any litigation expense which "concerns [a taxpayer's] capital assets" or could be said to constitute the protection of "ownership to its assets".

Justice Marshall stated in *Woodward* that the "primary purpose" rule "hardly draws a bright line," but that it may be the "best that can be devised" for litigation expense when the lawsuit somehow relates to or might indirectly affect a taxpayer's title to his property (397 U.S. at 576-77). The decision below has rubbed out that line as well as other well established guidelines for taxpayers.

In *Woodward* and *Hilton Hotels* the Court granted certiorari to resolve a conflict over the deductibility of the costs of appraisal proceedings. Certiorari should be granted here because the decision below has created conflict in a situation which is much more prevalent—the tax treatment of expenditures arising from any type of legal proceeding which could be said to "concern" capital assets.

4. The Court of Appeals Erred in Substituting Its Own Findings For The Findings Of Fact Of The Trial Court.

At the conclusion of the trial the District Court found as facts that the five year pendency of the Borg-Warner action had had "an adverse effect upon [Anchor's] day-to-day operations", and that "as the result of the [Borg-Warner] litigation, [a] Anchor curtailed necessary expenditures despite rapidly increasing demand", [b] "its sales and its income remained stagnant", and [c] its "competitive position within its industry deteriorated" (App. pp. 1-2). The trial judge also found that Anchor, prior to settling with Borg-Warner, was advised by its counsel that "the litigation would terminate favorably * * * but that an additional three to four years of litigation would be required [during which time] the adverse effect of the litigation upon [Anchor's] operations would continue" (App. p. 2). The trial judge concluded that "Anchor's title to its assets was not a disputed issue in the Borg-Warner litigation" and that Anchor, as a matter of fact, paid the $600,000 to Borg-Warner to be free of "the constraints imposed upon its business operations by the pendency of the litigation" (App. pp. 1-2).

The Court of Appeals opinion, in effect, labeled these findings of fact of the trial court as "subjective considerations", "formalizing and artificial distinctions" (App. p. 12) and found, squarely contrary to the trial court's determination, that "Anchor protected ownership to its assets by removing Borg-Warner's claim through the settlement payment of $600,000". (App. p. 13). In so doing, the Court of Appeals ignored the requirement of Rule 52(a) FRCP that the findings of fact of the trial court who heard and saw the witnesses "shall not be set aside unless clearly erroneous".

The Court of Appeals erred separately in a similar fashion when it rejected the District Court's findings of fact as to the origin and character of the Borg-Warner claim against Anchor. The District Court, following the teaching of *Gilmore* v. *U.S.*, 372 U.S. 39 (1963), which directs the trier of fact to look into the "origin" and "character" of the claim giving rise to litigation, had isolated the origin of Borg-Warner's claim in its findings of fact as follows:

> "In January and February, 1956, the principal officers and stockholders of plaintiff, Charles Conroy and Walter Fritsch, engaged in negotiations with Borg-Warner Corporation with respect to sale to Borg-Warner of plaintiff's assets for the sum of $4,025,000. These negotiations were similar in kind to negotiations which had occurred within the prior five years with other prospective acquirers of Anchor's assets. Such negotiations were normal occurrences in the operations of business concerns situated similarly to plaintiff.
>
> "In September, 1956, negotiations with Borg-Warner were broken off by plaintiff, and Borg-Warner filed suit in October, 1956, for specific performance of an alleged contract for the sale of Anchor's assets. At no time did Borg-Warner question the validity of Anchor's title to its assets. All pleadings filed on behalf of Borg-Warner pre-supposed the validity of Anchor's title. Anchor's title to its assets was not a disputed issue in the Borg-Warner litigation." (App. p. 1).

But the Court of Appeals held: "The origin and nature of the claim by Borg-Warner *** directly concerns Anchor's capital assets" (App. pp. 12-13). This squarely contradicts the District Court's finding of fact that the origin of Borg-Warner's claim was in the abandonment of negotiations with prospective acquirers of Anchor's assets, negotiations which at that time were "normal occurrences in the operations of business concerns situated similarly to [Anchor]" (App. p. 1).

Therefore, in two critical areas the Court of Appeals erred in substituting its findings for findings of the District Court.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Seventh Circuit. Under the circumstances, petitioner suggests that a summary reversal is appropriate.

Respectfully submitted,

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Of Counsel:

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CERTIFICATE OF SERVICE

I hereby certify that on this 24th day of October, 1970 three copies of the Petition for Writ of Certiorari were mailed, postage prepaid, to The Solicitor General, Department of Justice, Washington, D.C. 20530. Three additional copies were mailed to the Department of Justice attorneys who appeared for the government in the United States Court of Appeals for the Seventh Circiut.

PATRICK W. O'BRIEN
231 S. La Salle Street
Chicago, Ill. 60604
One of the Counsel for Petitioner

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[Caption Omitted]

FINDINGS OF FACT

1. Plaintiff, Anchor Coupling Co., Inc. (hereinafter "Anchor") is a corporation whose principal offices and principal manufacturing facilities are located in Libertyville, Illinois.

2. In January and February, 1956, the principal officers and stockholders of plaintiff, Charles Conroy and Walter Fritsch, engaged in negotiations with Borg-Warner Corporation with respect to sale to Borg-Warner of plaintiff's assets for the sum of $4,025,000. These negotiations were similar in kind to negotiations which had occurred within the prior five years with other prospective acquirers of Anchor's assets. Such negotiations were normal occurrences in the operations of business concerns situated similarly to plaintiff.

3. In September, 1956, negotiations with Borg-Warner were broken off by plaintiff, and Borg-Warner filed suit in October, 1956, for specific performance of an alleged contract for the sale of Anchor's assets. At no time did Borg-Warner question the validity of Anchor's title to its assets. All pleadings filed on behalf of Borg-Warner presupposed the validity of Anchor's title. Anchor's title to its assets was not a disputed issue in the Borg-Warner litigation.

4. The pendency of this litigation in the five years between October, 1956 and November, 1961 had an adverse effect upon plaintiff's day-to-day operations. On advice of counsel, and as the result of the litigation, Anchor curtailed necessary expenditures despite rapidly increasing demand. As a result of the pendency of the Borg-Warner litigation, plaintiff's sales and its income remained stag-

nant. As a further result of the pendency of the Borg-Warner litigation, plaintiff's competitive position within its industry deteriorated.

5. In September and October, 1961 there were settlement discussions with a representative of Borg-Warner, as a result of which agreement was reached whereby the litigation would be settled and dismissed by payment of $1,000,000 to Borg-Warner, and of this sum plaintiff would contribute $600,000. This proposed settlement was submitted for approval to plaintiff's shareholders on October 26, 1961 with the recommendation of plaintiff's counsel, Mr. Robert Burdett, that the settlement be approved. Mr. Burdett stated his belief that the litigation would terminate favorably to plaintiff if carried to conclusion, but that an additional three to four years of litigation would be required and that the adverse effect of the litigation upon plaintiff's operations would continue. The settlement was approved by plaintiff's shareholders on October 26, 1961, and by plaintiff's Board of Directors on March 10, 1961. The sum of $600,000 was paid by plaintiff to Borg-Warner on November 14, 1961.

6. Plaintiff's $600,000 payment to Borg-Warner was made in good faith and was reasonable in amount. The payment was made with a present business purpose to free plaintiff from the constraints imposed upon its business operations by the pendency of the litigation. The $600,000 payment in question bore a direct and proximate relationship to plaintiff's operations and to the production of income from such operations and was made to conserve and protect property held by plaintiff for the production and generation of income.

7. On its U.S. Income Tax Return for the fiscal year ending June 30, 1962, plaintiff deducted the $600,000 pay-

ment as an ordinary and necessary business expense. This deduction was disallowed by the Internal Revenue Service and a deficiency assessed. On September 15, 1966, the sum of $382,353.12 was, in legal effect, paid by plaintiff which sum represented the increased tax due, together with interest thereon, as a result of the disallowance of the $600,000 deduction. On January 9, 1967, plaintiff filed its Claim for Refund which was disallowed in full on June 9, 1967. The present action was commenced on September 25, 1967.

8. The Findings of Fact set forth above were established either by stipulation or by plaintiff from its books and records and from the testimony of the witnesses called in plaintiff's behalf, which testimony the Court expressly accepts as true.

CONCLUSIONS OF LAW

1. The Court has jurisdiction of the parties and of the subject matter. 28 U.S.C. § 1346(a)(1).

2. Plaintiff has fulfilled all conditions precedent to the maintenance of this action and the action has been timely filed.

3. Plaintiff has established by a preponderance of the evidence that its payment to Borg-Warner of the sum of $600,000 on November 14, 1961 was an ordinary and necessary business expense within the meaning of Section 162 (a) of the Internal Revenue Code, 1954. Kornhauser v. U.S., 276 U.S. 145 (1928); Comm'r v. Heininger, 320 U.S. 467 (1943); Comm'r v. Tellier, 383 U.S. 687. Plaintiff has established by a preponderance of the evidence that the $600,000 payment was not made in defense of title within the meaning of Section 1.263(a)-2(c) of the Regulations to the Internal Revenue Code, 1954. L. B. Reakirt, 29

B.T.A. 1296 (1934), aff'd 84 F.2d 996 (6th Cir. 1936); Ruoff v. Comm'r, 277 F.2d 222 (3rd Cir. 1960); Allied Chemical Corp. v. U.S. 305 F.2d 433 (Ct. Cl. 1962); Alleghany Corp., 28 T.C. 298 (1957), acquiescence 1957-2 Cum. Bul. 3; Rassenfoss v. Comm'r, 158 F.2d 764 (7th Cir. 1946).

4. Deduction as an ordinary and necessary business expense on plaintiff's U.S. Income Tax Return for the fiscal year ending June 30, 1962 of plaintiff's $600,000 payment to Borg-Warner on November 14, 1961 was erroneously disallowed by defendant, and plaintiff, accordingly, is entitled to judgment in the sum of $382,353.12 with interest thereon as provided by law from September 15, 1966.

/s/ J. S. Perry
United States District Judge

Date: 3-28-69

[Caption Omitted]

May 28, 1970

Before SWYGERT, *Chief Judge*, CUMMINGS, *Circuit Judge*, and GRANT, *District Judge*.[1]

SWYGERT, *Chief Judge*. This is a suit for refund of $382,353.12, representing taxes and interest which the Anchor Coupling Company, Inc. paid after the Commissioner of Internal Revenue disallowed a $600,000 deduction on taxpayer's federal income tax return for its fiscal year ending June 30, 1962. The issue is whether the district court correctly ruled that the $600,000 paid

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[1] Chief Judge Robert A. Grant is sitting by designation from the United States District Court for the Northern District of Indiana.

by taxpayer in settlement of litigation seeking specific performance of an alleged contract for the sale of Anchor's assets to the Borg-Warner Corporation was deductible as an ordinary and necessary business expense rather than a nondeductible capital expenditure. We hold that the $600,000 payment was a nondeductible capital expenditure and, therefore, reverse.

Anchor Coupling Company is an Illinois corporation having its principal office in Libertyville, Illinois. The founders of the company were Charles Conroy and Walter Fritsch. In 1956 Conroy and Fritsch owned approximately ninety per cent of Anchor's outstanding stock. Early in that year they entered into negotiations for the sale of Anchor's assets to Borg-Warner. On February 20 Borg-Warner wrote Anchor setting forth a proposed agreement which gave Borg-Warner a sixty-day option to purchase Anchor's assets. On February 29 Anchor replied, stating in substance that its assets could be purchased for $4,025,000, provided suitable assurance was given that Anchor's lower level executive personnel would be retained by Borg-Warner. The letter was characterized by the Illinois Supreme Court as a "counter offer."

Thereafter it became apparent that Borg-Warner intended upon consummation of the sale to reduce the salaries and responsibilities of certain executives and that some of the executives intended to seek employment elsewhere. As a result Conroy, over the opposition of Fritsch, decided to terminate the negotiations and to resist, by litigation if necessary, Borg-Warner's efforts to acquire Anchor's assets.

On November 3, 1956 Borg-Warner filed a complaint in the Circuit Court of Lake County, Illinois against Fritsch, Conroy, and Anchor, alleging that the inter-

company correspondence between Anchor and Borg-Warner constituted a contract for the sale of Anchor's assets and seeking specific performance. In May 1957 the Circuit Court dismissed the complaint on the grounds that Borg-Warner failed to allege a completed contract and that the alleged negotiations, even if they constituted a contract, were unenforceable by reason of the staute of frauds. Borg-Warner filed an amended complaint which was dismissed on similar grounds. On appeal the Illinois Supreme Court reversed, holding that the amended complaint stated a cause of action and remanded the case for trial to determine whether the parties had entered into a binding contract. *Borg-Warner Corp.* v. *Anchor Coupling Co., Inc.*, 16 Ill.2d 234, 156 N.E.2d 513 (1958).

Trial before the court commenced on May 24, 1961, but was adjourned for the summer after two days of testimony. On July 5, 1961 Fritsch died. His son, John, and William Funck, as executor of the estate, became representatives of the Fritsch interests in Anchor. Thereafter, Anchor contacted Borg-Warner concerning a possible settlement of the litigation. In October 1961 a settlement was reached. In return for relinquishing all claim to Anchor's assets and dismissing its suit, Borg-Warner received $1,000,000. As between the several representatives of the taxpayer, Conroy paid $150,000, the Fritsch estate $250,000, and Anchor $600,000.

Anchor deducted the $600,000 payment as an ordinary and necessary business expense on its federal income tax return for its fiscal year ending June 30, 1962. The Commissioner of Internal Revenue disallowed the deduction on the ground that the payment was a nondeductible capital expenditure. Anchor paid the tax and interest due as a result of the disallowed deduction and filed a claim for refund. The claim was disallowed, and the present suit followed.

The district court found that the pendency of the Borg-Warner litigation, from October 1956 to November 1961, had "an adverse effect upon plaintiff's [Anchor] day-to-day operations." Specifically the court determined that as a result of the litigation Anchor's sales and income "remained stagnant" and its competitive position "deteriorated" during a time of "rapidly increasing demand" when Anchor, because of the suit, "curtailed necessary expenditures." As a result the court concluded that:

> Plaintiff's $600,000 payment to Borg-Warner was made in good faith and was reasonable in amount. The payment was made with a present business purpose to free plaintiff from the constraints imposed upon its business operations by the pendency of the litigation. The $600,000 payment in question bore a direct and proximate relationship to plaintiff's operations and to the production of income from such operations and was made to conserve and protect property held by plaintiff for the production and generation of income.

Accordingly, the court held that the payment to Borg-Warner of $600,000 was an ordinary and necessary business expense and ordered the Government to pay Anchor $382,353.12 plus interest from September 15, 1966. This appeal followed.

The only question in this appeal is whether the $600,000 settlement of the Borg-Warner litigation was an ordinary and necessary business expense deductible from current income under section 162(a)[2] of the Internal Revenue Code

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[2] Section 162 of the Internal Revenue Code of 1954 reads in pertinent part:

> (a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business including—
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> • • •

of 1954, or a nondeductible capital expenditure under section 263 of the Code.[3] In holding that the settlement payment was an ordinary and necessary business expense, the district court relied primarily upon two factors: (1) the effect of the Borg-Warner claim and litigation on Anchor's operations and the possible consequences of not settling the claim on taxpayer's business; and (2) Anchor's primary motivation in making the settlement was to avoid the consequences noted in (1) and to improve its earnings from current operations. Under the "primary purpose" test applied in previous cases these factors may be relevant in determining whether or not expenditures are deductible as payments made to protect ownership or to defend title to a capital asset. *Rassenfoss* v. *Commissioner*, 158 F.2d 764 (7th Cir. 1946); *see generally*, cases collected in 4A, J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 25.24, 25A.16 (1966 ed.). The Government urges that the primary purpose test is no longer the appropriate test in light of the Supreme Court's decisions in *United States* v. *Gilmore*, 372 U.S. 39 (1963); *Woodward* v. *Commissioner*, 38 U.S.L.W. 4319 (April 20, 1970); and *United States* v. *Hilton Hotels Corp.*, 38 U.S.L.W. 4321 (April 20, 1970). We agree and hold that the district court erred in considering the possible consequences of the failure to settle on Anchor's current operations and the taxpayer's motives in entering into the settlement.

In *Gilmore* the Supreme Court was asked to determine whether litigation expenses were deductible business ex-

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[3] Section 263 of the Internal Revenue Code of 1954 reads in pertinent part:

(a) *General Rule.*—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

penses or nondeductible personal expenses. The taxpayer and his wife were engaged in a hotly contested divorce proceeding. The taxpayer believed that loss of the divorce proceeding would threaten his controlling stock interest in an auto dealership and, by damaging his reputation, would endanger his ability to renew his General Motors franchise. He, therefore, deducted over $40,000 in legal expenses as an ordinary and necessary business expense. The Commissioner denied the deduction, but the Court of Claims held that eighty per cent of the expenses were deductible as defending community property claims against the taxpayer's stockholdings. The Supreme Court reversed, holding that the Court of Claims had applied the wrong test in determining whether the legal expenses of the taxpayer were personal expenses or ordinary and necessary business expenses. The Court stated the proper test as follows: "[T]he origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal' and hence whether it is deductible or not under § 23(a)(2)." [Section 212 of the 1954 Code.] *United States* v. *Gilmore*, *supra*, at 49.

In the *Woodward* and *Hilton Hotels* cases the Court was asked to determine whether expenses in connection with appraisal litigation were capital expenditures incurred in the acquisition or disposition of a capital asset. In *Woodward* taxpayers controlled a majority of common stock in an Iowa publishing corporation. In 1960 the taxpayers voted their controlling shares in favor of perpetual extension of the corporate charter. Under Iowa law the majority shareholders were required to purchase the stock of shareholders who voted against renewal of the charter. The Eighth Circuit held that these expenses were nondeductible capital ex-

penditures, *Woodward* v. *Commissioner*, 410 F.2d 313 (1969). The *Hilton Hotels* case concerned litigation expenses incurred pursuant to New York law in connection with the valuation of the shares of persons objecting to the merger of Hilton Hotels Corporation and Hotel Waldorf-Astoria Corporation. This court applied the primary purpose test announced in *Rassenfoss* v. *Commissioner*, 158 F.2d 764 (7th Cir. 1946), and held that "the proceeding was not necessary to the consummation of the merger nor did it function primarily to permit the acquisition of the objecting holders' shares," and that "the paramount purpose of the appraisal proceeding was to determine the fair value of the dissenting stockholders' share in Waldorf." *United States* v. *Hilton Hotels Corp.*, 410 F.2d 194, 197 (1969). Accordingly, we held post-merger appraisal expenses were deductible as ordinary and necessary business expenses.

The Supreme Court reversed our decision in *Hilton Hotels* and affirmed the Eighth Circuit's decision in *Woodward*. In so doing the Court held that the test to be applied in determining whether costs are incurred in the acquisition of a capital asset is a simple "inquiry whether the origin of the claim litigated is in the process of acquisition itself." *Woodward* v. *Commissioner*, *supra*, at 4320. The Court rejected the application of the primary purpose test in this area noting that: "A test based upon the taxpayer's 'purpose' in undertaking or defending a particular piece of litigation would encourage resort to formalisms and artificial distinctions." *Woodward* v. *Commissioner*, *supra*, at 4320. As the Court recognized, this approach fully comports with "objective" principles of deductibility established in *Gilmore*.

In *Woodward* in discussing its rejection of the primary purpose test proposed by this court in *Hilton Hotels*, the Court noted briefly the application of that theory to costs of defending title to a taxpayer's property. The primary

purpose test has never been directly reviewed by the Supreme Court and has been developed entirely by lower courts. As the Court explained: "This test [the primary purpose test] hardly draws a bright line, and has produced a melange of decisions, which, as the Tax Court has noted, 'it would [sic] idle to suggest . . . can be reconciled.' *Hermann F. Ruoff*, 30 T.C. 204, 208 (1952)." *Woodward* v. *Commissioner*, *supra*, at 4320. However, the Court did not intimate the extent to which the primary purpose test, as applied to costs incurred in protecting ownership, has been rejected by the adoption of an objective standard of deductibility in *Gilmore* and *Woodward*.[4] We are convinced that the considerations which prompted the Court to announce such a test in these cases also impel us to fashion a similar test for determining whether the settlement payment in this case is a business expense or a capital expenditure.

In so doing we rely particularly on *Gilmore*. Taxpayer argues that *Gilmore* is inapplicable because we are asked here to determine whether a settlement constitutes an ordinary and necessary business expense or a capital outlay and not whether a payment is a deductible business expense or a nondeductible personal expense. We disagree. Although the two questions are admittedly different, substantially the same problems arise in each determination. Thus in both cases the court must determine the tax consequences of monetary outlays made in connection with contesting a claim on the taxpayer's assets. Con-

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[4] The Court merely noted: "That uncertain and difficult test may be the best that can be devised to determine the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property more or less indirectly, and that this calls for a judgment whether the taxpayer can fairly be said to be 'defending or perfecting title'." *Woodward* v. *Commissioner*, 38 U.S.L.W. 4319, 4320 (April 20, 1970).

sideration of the taxpayer's motive and the consequences of his failure to make a payment or to incur an expense create the same problems in both cases. For the deductibility of payments to depend upon such elusive determinations causes tremendous difficulties for the administration of the tax laws. Further, for deductibility to depend upon subjective considerations encourages schemes of tax avoidance and, as the Supreme Court noted in *Gilmore*, can lead to capricious results and a concomitant lack of uniformity in the application of our tax laws. Finally, as the Court noted in *Woodward*, a test based upon taxpayer's purpose in defending or settling litigation would encourage resort to "formalisms and artificial distinctions."

Taxpayer seeks to avoid these conclusions by arguing that here, as in contrast to *Gilmore* and *Woodward*, considerations of motive and the consequences on his business operations are necessary to determine whether the payment is made to protect or defend business property of the taxpayer. We see no such distinction. Admittedly, a settlement payment may have significant effect on current business operations, but as much could also be said for the legal expenses in *Gilmore*, or for that matter, the purchase of many capital assets. Accordingly, we hold that the origin and character of the claim with respect to which a settlement is made, rather than its potential consequences on the business operations of a taxpayer is the controlling test of whether a settlement payment constitutes a deductible expense or a nondeductible capital outlay.

When this test is applied to the instant case, it is evident that the Commissioner was correct in denying the deduction claimed by Anchor. The origin and nature of the claim by Borg-Warner, which was liquidated by Anchor's settlement payment, directly concerns Anchor's capital

assets. The alleged contract between Anchor and Borg-Warner created a claim on Anchor's assets by virtue of the doctrine of equitable conversion. Therefore, Anchor protected ownership to its assets by removing Borg-Warner's claim through the settlement payment of $600,000.

This analysis is supported by two cases which have held that settlement payments constituted capital expenditures on facts nearly identical to those before us. In *United States* v. *Wheeler*, 311 F.2d 60 (5th Cir. 1962), *cert. denied*, 375 U.S. 818 (1963), the taxpayer, owner of a corporation, contracted to sell his stock in the corporation for $1,000,000, but refused to complete the sale because he believed that he had been duped by the purchaser's attorney. The taxpayer subsequently settled a specific performance action brought by the purchaser for approximately $56,000. The Court of Appeals concluded that the facts "leave us in no doubt that the suit . . . was for specific performance and directly involved title to the stock in question." *United States* v. *Wheeler*, *supra*, at 63. Similarly in *Wise* v. *Commissioner*, 311 F.2d 743 (2d Cir. 1963), the taxpayer leased land under an agreement which gave the tenant an option to purchase. The tenant exercised the option and sued for specific performance when the taxpayer refused to convey the property. The court held that the $7,000 settlement payment was made by the taxpayer to preserve his title to the property and, therefore, denied his claim that the payment was deductible.

We think these cases demonstrate that payments made in settlement of actions for specific performance should be treated as capital transactions. Taxpayer cites five cases in support of his contention that the settlement payment in this case is deductible as an ordinary and necessary business expense. *Rassenfoss* v. *Commissioner*, 158 F.2d 764 (7th Cir. 1946); *Allied Chemical Corp.* v. *United States*,

305 F.2d 433 (Ct.Cl. 1962); *Ruoff* v. *Commissioner*, 277 F.2d 222 (3d Cir. 1960); *Allegheny Corp.* v. *Commissioner*, 28 T.C. 298 (1957); *Reakirt* v. *Commissioner*, 29 B.T.A. 1296 (1934). All of these cases employed the primary purpose test and concern transactions significantly different from that involved in the instant case. Under the objective test applied here many of the cases cited involve border line questions and perhaps would be decided differently. We decline to follow those cases to the extent that they are inconsistent with the result reached in this case.

The Government offers another argument which we think should be mentioned briefly to further buttress the result we have reached. It argues that the settlement and release received by Anchor in return for its settlement payment created enforceable rights in Anchor which constituted the acquisition of a capital asset. We agree that the transaction can also be viewed in this manner. Thus, if Anchor had completed the proposed sale of its assets by accepting $4,025,000 and then repurchased its assets for $4,625,000, it can hardly be doubted that the $600,000 premium would be included in the new book value of Anchor's assets. The settlement in this case accomplished an identical purpose and should be accompanied by identical tax treatment. *See American Dispenser Co., Inc.* v. *Commissioner*, 396 F.2d 137 (2d Cir. 1968).

The judgment is reversed.

April 21, 1970

Kenneth J. Carrick, Esquire
Clerk, U.S. Court of Appeals
for the Seventh Circuit

[Certain Caption Material Omitted]

Re: Anchor Coupling Co. v. United States
(C.A. 7th — No. 17,834)

Dear Mr. Carrick:

During the oral argument of the above-entitled appeal on February 17, 1970, Government counsel stated that the cases of *Woodward* v. *Commissioner* and *United States v. Hilton Hotels Corporation* involved issues which were relevent to the issues involved in the instant appeal and were to be argued in the Supreme Court shortly thereafter. On April 20, 1970, the Supreme Court decided the *Woodward* and *Hilton Hotels* cases in the Government's favor. For the convenience of the panel of your Court which heard the argument, four copies of these opinions are enclosed.

Sincerely yours,

JOHNNIE M. WALTERS
Assistant Attorney General
Tax Division

By: LEE A. JACKSON
Lee A. Jackson
Chief, Appellate Section

Enclosure
cc. George V. Bobrinskoy, Jr., Esquire
[Address Omitted]

[Caption Omitted]

PETITION FOR REHEARING, SUGGESTION OF IN BANC HEARING, AND REQUEST FOR CERTIFICATION

Plaintiff Anchor Coupling Co., Inc., for the reasons set forth below, hereby petitions for reconsideration of the opinion of the Court entered herein on May 28, 1970.

1. **The Supreme Court's Opinions Do Not Require The Overturning of Rassenfoss v. Comm'r.** The principal thrust of the Court's opinion is to reject the "primary purpose" test in determining present deductibility of expenses incurred in connection with "defense of title" litigation. In so holding, the Court in practical effect, and perhaps explicitly (Opinion, pp. 6, 9) has overruled its prior decision in *Rassenfoss* v. *Comm'r*, 158 F.2d 764 (7th Cir. 1946) which, together with Judge Blackmun's opinion in *Industrial Aggregate Co.* v. *U.S.*, 284 F.2d 639 (8th Cir. 1960), has constituted the leading decision holding that where expenses are incurred in connection with litigation wherein to some extent the taxpayer is "defending title" to an asset, the question whether the expenses may be presently deducted, or are required to be capitalized, hinges upon the "primary purpose" of the litigation. Both before the District Court, and on appeal, Anchor relied upon *Rassenfoss* to sustain its alternative position, i.e. even if the Borg-Warner litigation could be said in any sense to have raised questions concerning Anchor's title to its assets, the resolution of such questions clearly were not the "primary purpose" of the litigation.

The Court, in its opinion in the present case, has now held that rejection of the primary purpose test in "defense

of title" litigation is required by two recent decisions of the Supreme Court in *Woodward* v. *Comm'r*, 38 U.S.L.W. 4319 (April 20, 1970), and *U.S.* v. *Hilton Hotels Corp.*, 38 U.S.L.W. 4321 (April 20, 1970) and the somewhat older decision of *U.S.* v. *Gilmore*, 372 U.S. 39 (1963). This holding by the Court as to the effect of the three Supreme Court decisions, however, has been made entirely on its own initiative and, we submit, may needlessly present serious questions in the administration of the tax laws.

Very briefly stated, it is Anchor's position that both the *Hilton Hotels* and *Woodward* decisions of the Supreme Court rested on the determination that the expenditures there in question should be capitalized because they were incurred in the *acquisition* of property and that therefore there was no occasion to consider "primary purpose". However, the Supreme Court stated that, unless all litigation-connected expenditures are to be capitalized, the *Rassenfoss* "primary purpose" test "may be the best that can be devised to determine the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property more or less indirectly . . ." (38 U.S.L.W. at p. 4320).

Nor does *Gilmore* v. *U.S.*, 372 U.S. 39 (1963) destroy the authority of *Rassenfoss;* in fact, the Government's brief to this Court (p. 25) states that the *Rassenfoss* opinion "followed an approach quite similar to that later adopted by the Supreme Court in *United States* v. *Gilmore*". And the judgment below, like the *Rassenfoss decision*, is entirely consistent with *Gilmore*. *Gilmore* directs the trier of fact to examine the "origin" and "character" of the litigation or claim giving rise to the expenditure. This is precisely what Judge Perry did. He found the origin of the suit by Borg-Warner against Anchor in the break-down of certain negotiations—held to be normal occurrences in

the operations of business concerns situated similarly to Anchor (App. 83). Such findings of fact contradict any argument that Anchor's expenditure was capital in nature.

Both the judgment below and the *Rassenfoss* decision are consistent with *Gilmore*.

Nowhere in its arguments to this Court did the Government urge that the *Rassenfoss* decision be overruled. Decided in 1946, the *Rassenfoss* decision has, until now, been frequently cited and relied upon. Indeed when Congress passed the 1954 Internal Revenue Code, it may be said to have accepted and ratified the primary purpose test set forth in the *Rassenfoss* decision. Both the *Woodward* and *Hilton Hotels* opinions of the Supreme Court recognized that *Rassenfoss*, and cases relying upon *Rassenfoss*, had become an integral part of the law of Federal Income Taxation.

In view of this history and in view of the fact that the Supreme Court's opinions in *Woodward* and *Hilton Hotels* were handed down subsequent to the writing of briefs and the occurrence of oral argument in this case, we request that rehearing be granted, that the parties (and particularly the Government which, it may be expected, will have a comprehensive over-view of the effect upon enforcement of the tax laws of overturning this line of decisional law*) submit briefs with respect to the affect of the Supreme Court's decisions in *Woodward* and *Hilton Hotels* upon the issues in the present case and that oral argument

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* Some of the problems implicit in rejection of the primary purpose test with respect to "defense of title" litigation can be inferred from the fact that one of the decisions (*Allegheny Corporation*, 28 T.C. 298 (1957)) strongly relied upon by Anchor and rejected by the Court herein for employing the primary purpose test (Opinion, p. 9) was in fact acquiesced to by the Commissioner. 1957-2 Cum. Bull. 2

be held. For these reasons, and also because of the possible overruling of a leading case of this Circuit (the *Rassenfoss* decision) we believe that it would not be inappropriate if such a rehearing were to be to the Court sitting *in banc*, and we hereby so suggest pursuant to Rule 35(b) of the Rules of Appellate Procedure.

In the alternative, in view of the very drastic effect ascribed by the Court's May 28, 1970 opinion in the present case to the Supreme Court's opinions in *Woodward* and *Hilton Hotels*, we request that this Court, pursuant to its powers under Section 1254 of the Judicial Code, 28 U.S.C. § 1254, certify the question to the Supreme Court. If the Supreme Court intended to alter existing law to the extent indicated in this Court's opinion, then the Supreme Court should be given an opportunity to make its intent clear. Otherwise the intent of the Supreme Court in *Woodward* and *Hilton Hotels* will remain a matter of conjecture, and an unnecessary conjecture in view of this Court's certification power under Section 1254.

2. The Findings of Fact Bar A Reversal Whatever The Fate of The Primary Purpose Doctrine. Even if the Court should adhere to its opinion that the *Rassenfoss* decision is no longer valid in its emphasis upon examination into the primary purpose of the litigation to determine the deductibility of associated expenditures, nevertheless rehearing should be granted because the fundamental factual base for Judge Perry's decision allowing deductibility remains unaffected.

The only theory for requiring capitalization advanced by the Government at trial was the theory that Anchor's $600,000 payment to terminate the Borg-Warner litigation was made "in defense of title" to Anchor's assets within the meaning of the Regulations, 26 C.F.R. §§ 1.212-1(k),

1.263(a)-2(c). Thus a very narrow factual issue was presented by the Government with respect to the question of capitalization. Was Anchor's $600,000 payment made in defense of its *title* to its assets? On the evidence presented, the District Court concluded it was not.

Judge Perry heard the evidence adduced at trial and concluded that the issue of Anchor's "title" to its assets was never raised at any stage of the Borg-Warner proceeding. Judge Perry specifically found (App. 83-84) that Borg-Warner never questioned the validity of Anchor's *title* to its assets, that all pleadings filed on behalf of Borg-Warner presupposed the validity of Anchor's *title*, and that Anchor's *title* to its assets was not a disputed issue in the Borg-Warner litigation. Unlike the situation in *Rassenfoss* where title was an issue in the litigation although not the "primary purpose" of the litigation, in the Borg-Warner litigation *title* was not an issue at all.

Judge Perry's findings of fact are presumptively correct. Under Rule 52(a) of the Federal Rules of Civil Procedure these findings of fact are not to be set aside unless "clearly erroneous." This principle has been consistently followed by this Court, and the Supreme Court, in tax cases coming either from the Tax Court or from the District Court. *McGowan* v. *Comm'r*, 347 F.2d 728 (7th Cir. 1965); *Charter Wire, Inc.* v. *U. S.*, 309 F.2d 878 (7th Cir. 1962); *Rudolph* v. *U. S.*, 269, 270 (1962); *Comm'r* v. *Duberstein*, 363 U.S. 278, 289-91 (1960).

If the Court believes that Judge Perry applied an erroneous legal standard in reaching his finding that *title* was not at issue in the Borg-Warner litigation, then the proper remedy is to remand the cause for reconsideration in light of the correct legal standard. But, in fairness to the District Court and in fairness to the parties, the key

findings of fact which directly relate to the issues as framed at trial should not be ignored or dismissed.

3. **Necessity for further proceedings.** The mandate set forth at the end of the Court's opinion of May 28, 1970 states only that the District Court's judgment is reversed. If, upon remand, this mandate should be construed by the Government and the District Court to preclude further procedings, then a substantial injustice to Anchor would result.

Even if the Court should adhere to its opinion that Anchor's $600,000 payment in November, 1961 must be capitalized and added to the book value of Anchor's assets (Opinion pp. 9-10), Anchor would nevertheless be entitled to judgment for a substantial sum on its Claim for Refund for the fiscal year ending June 30, 1962.

The result of adding $600,000 to the basis of its assets under Section 1016(a) of the 1954 Internal Revenue Code will be, among other matters, to increase the deductions offsetting Anchor's ordinary income for the fiscal year ending June 30, 1962. For example, that portion of the $600,000 which is to be allocated to inventory (the asset accounting for approximately thirty-seven (37%) of the book value of Anchor's assets in November, 1961) will result in an increase of the cost of goods sold and a corresponding reduction in Anchor's ordinary income for that fiscal year. Similarly, insofar as the $600,000 payment is allocated to depreciable assets, Anchor will be entitled to increased deductions offsetting ordinary income in the fiscal year ending June 30, 1962 and for subsequent years.

We do not ask that the Court now rule upon any particular allocation of the $600,000 payment among Anchor's various assets. We simply request that if the Court's opinion is adhered to, then the mandate ought to be modi-

fied to read, "The Judgment is reversed and the cause remanded for further proceedings consistent with this opinion."

Respectfully submitted,

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